2.01 Revenue Recognition Overview & Step 1

Background

Until recently, U.S. GAAP recognized numerous revenue recognition principles. Some differed due to the industry, nature of the transactions, and a variety of other reasons. The FASB and the IASB developed a joint standard that replaces almost all of the individual revenue recognition standards that currently exist.

ASC 606, *Revenues from Contracts with Customers*, applies to all entities entering into **contracts with customers** unless the contracts are accounted for under another set of standards (eg, leases and insurance contracts).

Overview of Revenue Recognition Principles

The core revenue recognition principle consists of two components:

Revenue is to be recognized upon the **transfer** of promised goods and services to customers; and

The amount of revenue recognized represents the consideration the entity **expects to receive** in exchange for those goods and services.

Five-Step Process

Revenues are recognized by applying a *five-step process*:

1. Identify contracts with customers – Determine when:
   - An arrangement is considered a contract with customers.
   - Multiple contracts with the same customer should be combined and accounted for as a single contract.
2. Identify all separate performance obligations within each contract.
3. Determine the total consideration for the contract.
4. Allocate the total consideration among the separate performance obligations.
5. Recognize revenue, either:
   - *When* the entity has *satisfied* its performance obligations (eg, delivered products); or
   - *While* the entity is *satisfying* its performance obligations (eg, providing services).

1. Identify Contracts with Customers

There are two issues that must be addressed to determine if ASC 606 applies.

- For one, it must be determined that the counterparty to the transaction is a *customer*.
- Second, the arrangement must be a *legally binding contract*.

There is no requirement that the contract be in writing. It may be formal or informal, written or oral, and may even be implicit based on the normal manner in which the entities or individuals act (ie, in certain industries or specific circumstances).

A **customer** is defined as "a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration."

A **contract** is an arrangement between two or more parties that creates legally enforceable rights and obligations. If either party can terminate the arrangement without penalty prior to either party's performance, it is not considered a contract. A contract will conform to four criteria:

- The parties have approved the provisions and have *committed to perform*.
- The *rights* in the contract and the *payment terms* can be identified.[1]
- The contract has commercial *substance*.
- *Collection is probable* (ie, customer has the ability and intent to pay).

If all of the criteria are met, the arrangement is a contract with a bona fide customer and will be accounted for using the 5-step process. The arrangement does not have to be reevaluated again unless there is a significant change in the facts and circumstances (eg, collection becomes unlikely) or the arrangement is modified.

Revenue Arrangements that are Not Contracts with Customers

An entity may enter into an arrangement that has some of the characteristics of a revenue-related contract in that it involves providing goods/services in exchange for compensation. It may not, however, meet all of the criteria. As long as the arrangement does not meet the criteria, all amounts received will be recognized as a *liability*.

Cash	XX	
Deferred revenue		XX

The arrangement will be reevaluated every reporting period to determine whether it has met the criteria, at which time the method of accounting will be changed to the 5-step process.

If the criteria are never met, the liability is *derecognized* and treated as *revenue* when *consideration* received from the customer is *nonrefundable and one of the following* scenarios applies:

Deferred revenue	XX	
Revenue		XX

Scenario 1	Scenario 2	Scenario 3
• The entity has *no remaining obligations*, and • All, or substantially *all*, of the *consideration* has been *received*.	• The arrangement has been *terminated*.	• Consideration received relates to *goods/services*, the control of which, has been *transferred*; and • The entity has stopped transferring goods/services, and neither has an obligation to, nor intends to, provide any additional goods/services.

[1] *FASB separates rights and payment terms into two separate criteria. Since rights and obligations go hand-in-hand, we combined them to reduce the number of criteria to remember.*

Combining Contracts

In general, each contract is considered a separate accounting unit; thus, each contract is evaluated and accounted for separately. There are circumstances in which an arrangement with a customer appears to be numerous contracts but in substance they are equivalent to a single contract. This may be done for a variety of reasons, but most provide the seller with the opportunity to accelerate or delay the recognition of revenue.

Contracts should be **combined** if one or more of the following criteria are met:

- Contracts are negotiated as a **single package** with a single commercial objective.
- **Price** to be paid in one contract **depends on** the price or performance of **other contracts** (multiple deliverables).
- Goods/services promised in the contracts are a **single performance obligation**.

Package with Single Objective

In some cases, two or more *contracts are negotiated as a package with a single objective*. These contracts will be combined and accounted for as if they were a single contract.

For example, a manufacturer may purchase several pieces of equipment from a single supplier, each on a separate contract, with all the equipment intended to be part of an assembly line. Assume none of the equipment will be used for any other purpose and that the assembly line requires the use of all the equipment. Since the buyer doesn't have resources that can be readily put to use until they receive all of the equipment, the contracts should be combined.

Price Depends on Other Contracts

When multiple deliverables are involved, a seller could accelerate the recognition of revenue by placing all items to be delivered in the current period into one contract at inflated prices, and all items to be delivered in a subsequent period into a separate contract at discounted prices. Thus, when the consideration agreed upon for one contract is affected by the consideration agreed upon for another contract, the contracts should be combined and accounted for as a single contract.

For example, an entity may be selling two identical machines using separate contracts, each of which has a normal sales price of $100,000. One may be scheduled for delivery in the current fiscal period and the other scheduled for delivery in the next fiscal period.

The seller may attempt to accelerate revenue recognition by establishing a contract price of $150,000 for the machine to be delivered in the current period and only $50,000 for the one to be delivered in the next period.

The seller would not likely sell the second machine for $50,000 if the first one was not sold to the same customer for $150,000. Thus, the prices are interdependent, the contracts would be combined, and the two machines will be accounted for as two identical performance obligations that are part of a single contract. The total consideration of $200,000 will be allocated $100,000 to each machine.

Single Performance Obligation

Contracts will also be combined when *the goods/services called for in two or more contracts constitute a single performance obligation*. This would be the case if the customer is unable to benefit from the goods/services received in one contract without the goods/services in the other.

For example, assume an entity was to sell the shell of a piece of equipment to a customer in one contract and the working parts of that equipment in another. This arrangement will be evaluated to determine if the customer can benefit from one without the other.

If the equipment is not unique, the customer may be able to acquire all of the working parts for the equipment from another supplier and could benefit from receiving just the shell. Since the customer could benefit from one without the other, they represent distinct performance obligations, with revenue recognized as each performance obligation is satisfied.

If, however, the working parts were not readily available to the customer from another supplier, they would be considered a single performance obligation and the contracts would be combined.

In some cases, contracts having similar characteristics may be combined into a **portfolio** and treated as a single contract. This would be done to reduce the cost and burden associated with doing a lot of contracts, especially if they are not individually material.

Contract Modifications

When a contract is modified, the nature of the modification will dictate the accounting treatment to be applied.

- Some contract modifications are treated as *new, separate contracts*.
- Others are considered effective *terminations* of the existing contract, *replacing* it with a *new contract.*
- The remaining modifications are treated as an *adjustment to an existing contract*.
- Some modifications represent some *combination* of these alternatives.

A modification may be in the form of an amendment, a change order, or a variation. It may be written, oral, or implicit from the behavior of the parties. When a modification involves a change in the consideration in an unknown amount, the change will be estimated using the same approaches that are used to estimate variable consideration (discussed later).

In addition, the estimate of the change in price is subject to the constraint on estimates of variable consideration. It requires that it be probable that, when the uncertainty is resolved, there will be no significant reversal of the cumulative amount of revenue that has already been recognized. In applying the constraint, the likelihood and magnitude of a potential reversal are considered.

New, Separate Contract

A contract modification is considered a new, separate contract when the modification calls for an *increase* in *both* the *scope* and *price* (ie, for additional distinct goods/services). A modification of this sort is accounted for by applying the 5-step process.

Cancellation with New Contract

A contract modification is treated as a cancellation of the existing contract accompanied by a new contract *when the performance obligations that remain unsatisfied are distinct* from those that have

been satisfied up through the date of the modification. Total consideration for the new contract will be equal to:

- The remainder of the consideration from the original contract that has not yet been recognized, plus
- Any additional consideration resulting from the modification.

The total consideration for the new contract will be allocated among all remaining performance obligations, including those from the original contract and any new ones added. The entity will use the same 5-step process for recognizing revenue on the new contract.

Adjustment to Existing Contract

When remaining goods/services that are yet to be delivered do not represent distinct performance obligations, they are combined into a single performance obligation that is considered partially satisfied. Total consideration will consist of the original amount combined with any adjustments resulting from the modification. This will be applied to the single performance obligation, including the changes that result from the modification.

- If the contract qualifies for revenue recognition while the performance obligation is being met, revenue is recognized in the current year on a catch-up basis. The amount of revenue that would have been earned if the contract had originally been analyzed with the modification included is reduced by revenues recognized to date, with the difference recognized in the current period.
- If the contract does not qualify for revenue recognition while the performance obligation is being satisfied, balance sheet accounts will be adjusted for additional amounts received and costs incurred; however, no revenue will be recognized until the single performance obligation has been satisfied.